PROFESSOR SHAIKH: Thank you Mr. Chairman, Mr. Vice Chairman and members of the Commission.

I'd like to focus on the structural components of the balance of trade, a component which is linked to long-term patterns of competitiveness and growth. In so doing, I'd like to consider the balance of trade in terms of the ratio of exports to imports because this has the convenience of being decomposable into a price term and a quantity term. I ask you, therefore, to look at page 4 of my written testimony in which I have three figures at the very top.

Each figure represents an actual variable and a trend line which for the purpose of discussion roughly represents the structural component.

Figure 2 represents the terms of trade of the U.S., Figure 3 represents the real export-import ratio and Figure 4 represents the product of the two which is the balance of trade expressed as the ratio of the value of exports to imports.

In looking at this data, it is quite striking that the real export-import ratio (Figure 3) rises fairly modestly whereas the terms of trade (Figure 4) drops quite rapidly. This makes it evident that it is the terms of trade which is the central factor in the drop in the nominal balance of trade in Figure 4, as you can see, the balance of trade which is the ratio of nominal exports to imports, drops sharply in line with the general fall in the terms of trade.

The fact that the terms of trade are central to the drop in the balance of trade is very problematic from the point of standard theory. This is because standard theory relies on the principle of comparative advantage and that principle says that the terms of trade should move automatically to make trade balanced. What we find instead is that they are actually a central factor in making trade imbalanced.

In contrast to conventional theory, I'd like to argue that foreign trade actually operates very much like trade within a nation, and looking at it that way it greatly enhances our understanding of the patterns we actually observe.

The first step in moving to this alternate perspective is to recognize that the terms of trade is simply a relative price regulated by relative costs, of which unit labor costs are a very central factor.

The second step is to consider what might happen if there was trade between two regions, one of which had higher costs than another within the same country. You would then find that the higher cost region would have trouble selling goods outside of the region, and would have a tendency to import goods into the region. In other words, a higher cost region would have a tendency to have a balance of trade deficit. This is perfectly well-known phenomena within countries and I have argued elsewhere on the theoretical grounds that the very same principle operates in international trade. That is to say, countries will tend to export those goods in which they have an absolute advantage and the international terms of trade will be regulated by relative real costs of the producers of exports. The terms of trade are, therefore, not free to also move so as to make trade balance, unless of course, real wages and/or productivity were determined by the requirements of trade balance. And they are most certainly not. So I ask you to now look at Figure 5 on Page 6 of my written testimony, which shows that the terms of trade of the United States move very closely with the real unit labor costs of the exports and imports involved. The sources and methods of these calculations are cited in my written submission.

It is particularly important to note that the real unit labor costs shown here do not include any exchange rate whatsoever. For each country, they are real wages (nominal wages in local currency divided by consumer price) divided by productivity.

So then the question arises, if the real unit labor costs have been falling in the U.S. relative to the rest of the world, why is the U.S. still running a trade deficit? I think that the answer has two components. One is that it has not fully caught up with its competitors, because while it has caught up to Japan and Europe, it has also been exposed to new competition from Asia where the costs are much lower. And secondly, of course, there are particular factors such as a long expansion in the U.S. since 1992 as well as the most recent Asian crisis which have made the balance of trade worse than it would have been otherwise.

There are some practical and policy implications of the approach I offer. One direct implication is that a focus on productivity growth should be an essential component of trade-related policy. But this can only happen if there is economic growth, because economic growth is required to put into place the new investment which is needed to raise productivity and lower real costs. It follows that we should see new economic growth not only as something that increases imports, but also as a means for increasing productivity and thereby improving exports and discouraging imports. The stronger the productivity growth, the more favorable will be the overall impact on the trade balance.